

Letter of Findings: 08-0514
Sales and Use Tax
For the Years 2003, 2004, 2005, 2006

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ISSUE

I. Sales and Use Tax – Manufacturing Exemption.

Authority: IC § 6-8.1-5-1; IC § 6-2.5-1-1 et seq; IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-5-3; [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-10](#); [45 IAC 2.2-5-12](#); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the imposition of use tax on some items.

STATEMENT OF FACTS

Taxpayer is an out-of-state manufacturer of bottled products and is registered in Indiana as a retail merchant. Taxpayer has a manufacturing facility in Indiana. Taxpayer makes only exempt sales to other entities and therefore does not collect sales tax on its sales. Taxpayer does accrue and pay use tax to the Indiana Department of Revenue ("Department") on taxable purchases for which Taxpayer had not paid sales tax at the time of purchase.

The Department conducted a sales and use tax audit of Taxpayer. Pursuant to the audit, the Department assessed additional sales and use tax on several items. Taxpayer agreed with some of the additional assessments, but protested the assessment on some items.

Taxpayer had also filed a claim for refund that was received by the Department on September 1, 2006. The refund claim was filed for sales tax paid on electricity and natural gas consumed in manufacturing. Taxpayer had previously had a predominant use of utilities exemption on the meters claimed for refund, but due to a relocation of the facility had to reapply for the exemption. The Department agreed that Taxpayer qualifies for the predominant use of utilities exemption and therefore sustained the refund claim.

A hearing was held on the protest of the use tax assessments and this Letter of Findings results. Additional facts will be provided as necessary.

I. Sales and Use Tax – Manufacturing Exemption.

DISCUSSION

Taxpayer protested four items the Department deemed non-exempt because of their use in pre-production and post-production processes rather than during the manufacturing process. Taxpayer had not paid sales tax when it purchased these items. Taxpayer protested that these items were used during the production process and therefore qualified for exemption from sales and use tax. The four contested items are: a de-palletizer, a box turner conveyor, a palletizer, and a stretch wrapper.

All tax assessments are prima facie evidence that the Department's claim for the tax is valid, and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

IC § 6-2.5-2-1 provides:

- (a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.
- (b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

IC § 6-2.5-3-2(a) provides:

An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

Accordingly, Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq. An exemption from the use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4.

Taxpayer contends that its use of the equipment qualified for an exemption, therefore, Taxpayer did not pay the sales tax at the time of purchase. Taxpayer asserts that the purchase of the equipment meets the "double direct" production exemption.

In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. IC § 6-2.5-5-3(b); [45 IAC 2.2-5-8\(a\)](#). The cited exemption only applies to manufacturing machinery, tools, and equipment directly used by

the purchaser in direct production. Id. Machinery, tools, and equipment are directly used in the production process if they have an immediate effect on the article being produced. [45 IAC 2.2-5-8\(c\)](#). A machine, tool, or equipment has an immediate effect on the product being produced if it is an essential and integral part of an integrated process that produces the product. Id. An integrated process is one where the total production process is comprised of activities or steps that are functionally interrelated and where there is a flow of "work-in-process." [45 IAC 2.2-5-8\(c\)](#), Example 1.

[45 IAC 2.2-5-8\(k\)](#) describes "direct production" as the performance of an integrated series of operations which transforms the matter into a form, composition or character different from that in which it was acquired, and that the change must be substantial resulting in a transformation of the property into a different and distinct product.

The exemption for direct use in production is further explained at [45 IAC 2.2-5-12](#) as follows:

(a) The state gross retail tax shall not apply to sales of tangible personal property to be directly used by the purchaser in the direct production or manufacture of any manufacturing or agricultural machinery, tools, and equipment described in [IC 6-2.5-5-2](#) or 6-2.5-5-3 [[IC 6-2.5-5-3](#)].

(b) The exemption provided in this regulation [[45 IAC 2.2](#)] extends only to tangible personal property directly used in the direct production of manufacturing or agricultural machinery, tools, and equipment to be used by such manufacturer or producer.

(c) The state gross retail tax shall not apply to purchases of tangible personal property to be directly used by the purchaser in the production or manufacturing process of any manufacturing or agricultural machinery, tools, or equipment, provided that the machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect upon the article being produced or manufactured. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

(d) For the application of the rules [subsections] above, refer to Regs. 6-2.5-5-3 [[45 IAC 2.2-5-8](#) through [45 IAC 2.2-5-10](#)] with respect to tangible personal property used directly in the following activities: pre-production and post-production activities; storage; transportation; tangible personal property which has an immediate effect upon the article produced; maintenance and replacement; testing and inspection; and managerial, sales, and other nonoperational activities.

(e) Energy equipment.

(1) Equipment used to modify energy purchased from public utilities for the production process is exempt if the equipment

(2) Equipment used to create energy that could otherwise be purchased exempt from a public utility for use by exempt equipment is exempt.

(3) When any equipment qualifies as essential and integral to the production process and also is used in an alternative nonessential and/or non-integrated manner, the exemption shall only apply to the percentage of use of the equipment used in the exempt manner.

[45 IAC 2.2-5-8\(d\)](#) states:

Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.

The Department's audit report describes Taxpayer's production process as follows:

The [drink] plant is a large manufacturing facility where product is manufactured in multiple size bottles as well as concentrate bags. A large finished goods warehouse is located at the end of the manufacturing process. In general, product is made in a mix room where various raw materials are mixed together including, but not limited to: plant filtered water, sugars, stabilizers, [...], and flavorings. Product is stored in large holding tanks prior to being sent to line for filling. The plant also maintains a water filtration/cleaning area where all water added to product is filtered using a reverse osmosis technique.

The main line and most of the large equipment is located in the main plant. Bottles, purchased by outside vendors, are brought in and placed onto de-palletizers. This equipment introduces bottles to the line for filling, cleaning and packaging. Bottles enter a cleaning area after introduction. Bottles then travel to various filling stations where mixed product is introduced. Pasteurization also takes place during this stage. Bottles are then capped and sent to cooling tunnels (to allow for proper labeling). Cooled bottles are labeled and then placed in various cases (or fit into various rings followed by casing). Cases are then sealed and labeled and transferred through a wall to the finished goods area where they are palletized and shrink wrapped. Production ends at the case packing area prior to entering the finished goods area.

A. Bottle De-Palletizers

According to the Department, Taxpayer receives bottles, purchased from outside vendors, on pallets. The bottles are put on equipment, the de-palletizers in question, which removes them from the pallets and introduces them to the main production lines. The Department determined that the de-palletizers were used before the actual production process began. Taxpayer disagrees stating, in an email dated March 11, 2009, that "as the empty bottles are removed from pallets, they are committed to the mfg [sic] process."

[45 IAC 2.2-5-10\(c\)](#) states:

Purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in processing or refining are exempt from tax; provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the tangible personal property being processed or refined. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which processes or refines tangible personal property.

–EXAMPLES–

(1) Whiskey is produced in a process that begins with the grinding and fermenting of grain and the distillation of the fermented mash, continues further with the maturation of the distilled alcohol and with the blending of individual whiskeys, and ends with the bottling, labeling, and packaging of the whiskey prior to shipment to customers. Because of the functional interrelationship of the various steps and the flow of the work-in-process, the total production process comprised of such activities is integrated.

(2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment is built in a manner to service various pieces of exempt equipment, as an alternative to building the equipment into each of the pieces of exempt machinery, is not determinative.

(A) Pumps used to circulate cooling water through exempt condensers in the distillery.

(B) Chemicals used to treat the water used in the production of whiskey to ensure that the water is pure or to prevent scale buildup in the boilers and pipes.

(C) Equipment used to pulverize coal prior to being fed into the exempt boiler used to generate steam in the distillation process.

(D) A bottling and packaging process, which includes equipment such as case and bottle conveyors used during the filling operations, equipment to fill the bottles with product and to place labels on the bottles, and case filling equipment and case palletizers. The exempt production process begins after the bottles are introduced onto the bottle conveyors for the filling step of production and ends with the final packaging of the product onto the case palletizers.

(3) Because of the lack of an essential and integral relationship with the integrated production process in Example (1), the following types of equipment are not exempt:

(A) Equipment and furnishings located in the administrative offices of the plant.

(B) Equipment used for research and development of new products.

(C) Equipment used periodically to test the purity of the water in on-site deep wells which supply the plant's water requirements.

(D) Racks on which cases of empty bottles are stored prior to their introduction into the bottling and packaging system.

(E) The depalletizer used to strip pallets from cases containing empty bottles and unscramblers used to move empty bottles out of cases and onto the production line.

(Emphasis added.)

[45 IAC 2.2-5-10\(c\)\(3\)\(E\)](#) unequivocally states that the de-palletizing equipment is not exempt. The Department's audit correctly assessed use tax on Taxpayer's de-palletizing equipment.

Taxpayer's protest of the assessment of use tax on its use of de-palletizing equipment is therefore denied.

B. Box Turner Conveyor and Palletizer

In its audit summary report the Department further describes Taxpayer's process as follows:

At the end of the production process, bottles are placed in their final cases. The product has already been labeled at this point. The cases travel on conveyors to a different area of the plant which could be described as finished goods. Here, cases are placed on palletizing machinery and subsequently shrink-wrapped. Most product is then directly stored in the attached finished goods warehouse before shipment.

Production ends at the point when a product is completed to its final form, including packaging as stated previously. The exemption does not include machinery used to apply shipping materials to such product.

Production ends when bottles and bladders are placed in their cases. Palletizing, stretch-wrapping, and related equipment are not exempt from tax.

Taxpayer argues that the box turner conveyor "turns" the boxed product so that it can be labeled. Taxpayer also cites to Letter of Findings # 99-0404 and to [45 IAC 2.2-5-10\(d\)](#) to support its contention that the palletizer is also exempt.

[45 IAC 2.2-5-10\(d\)](#) states:

Pre-processing and post-processing activities. "Direct use" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the processing or refining has altered the item to its completed form, including packaging, if required.

Letter of Findings # 99-0404 cited to [45 IAC 2.2-5-10\(c\)\(2\)\(D\)](#) in determining that palletizers were exempt. As quoted in the above section, [45 IAC 2.2-5-10\(c\)\(2\)\(D\)](#) states:

(2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment is built in a manner to service various

pieces of exempt equipment, as an alternative to building the equipment into each of the pieces of exempt machinery, is not determinative.

[...]

(D) A bottling and packaging process, which includes equipment such as case and bottle conveyors used during the filling operations, equipment to fill the bottles with product and to place labels on the bottles, and case filling equipment and case palletizers. The exempt production process begins after the bottles are introduced onto the bottle conveyors for the filling step of production and ends with the final packaging of the product onto the case palletizers.

Therefore, in the particular case of a bottling and packaging process, the production process "ends with the final packaging of the product onto the case palletizers." Using the cited example as the benchmark, the Department concludes that Taxpayer's own palletizer and box turner conveyor are entitled to the exemption provided under [IC 6-2.5-5-3\(b\)](#). In addition – using the palletizer as a reference – the Department concludes that the box turner conveyor is entitled to this same exemption since its use in the process precedes that of the palletizer.

Taxpayer's protest of the assessment of use tax on its use of a box turner conveyor and palletizing equipment is therefore sustained.

C. Stretch Wrapping Equipment

Taxpayer also cites to Letter of Findings # 99-0404 and to [45 IAC 2.2-5-10\(d\)](#) to support its contention that the stretch wrapping equipment is also exempt.

[45 IAC 2.2-5-10\(d\)](#) states:

Pre-processing and post-processing activities. "Direct use" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the processing or refining has altered the item to its completed form, including packaging, if required.

Again, as quoted in the above section, [45 IAC 2.2-5-10\(c\)\(2\)\(D\)](#) states:

(2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment is built in a manner to service various pieces of exempt equipment, as an alternative to building the equipment into each of the pieces of exempt machinery, is not determinative.

[...]

(D) A bottling and packaging process, which includes equipment such as case and bottle conveyors used during the filling operations, equipment to fill the bottles with product and to place labels on the bottles, and case filling equipment and case palletizers. The exempt production process begins after the bottles are introduced onto the bottle conveyors for the filling step of production and ends with the final packaging of the product onto the case palletizers.

According to the above referenced statute, the production process "ends with the final packaging of the product onto the case palletizers." Taxpayer's process has ended at this point.

[45 IAC 2.2-5-16](#) provides

(a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers sold empty for refilling.

(b) In general the gross proceeds from the sale of tangible personal property in a transaction of a retail merchant constituting selling at retail are taxable. This regulation [[45 IAC 2.2](#)] provided an exemption for wrapping materials and containers.

(c) General rule. The receipt from a sale by a retail merchant of the following types of tangible personal property are exempt from state gross retail tax:

(1) Nonreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property.

(2) Deposits for returnable containers received as an incident to a transaction of a retail merchant constituting selling at retail.

(3) Returnable containers sold empty for refilling.

(d) Application of general rule.

(1) Nonreturnable wrapping material and empty containers. To qualify for this exemption, nonreturnable wrapping materials and empty containers must be used by the purchaser in the following way:

(A) The purchaser must add contents to the containers purchased; and

(B) The purchaser must sell the contents added.

(2) Returnable containers sold at retail with contents. To qualify for this exemption, the returnable containers must be:

(A) Sold in a taxable transaction of a retail merchant constituting selling at retail; and

(B) Billed as a separate charge by the retail merchant to his customer. If there is a separate charge for such containers, the sale of the container is exempt from tax under this regulation [[45 IAC 2.2](#)].

(3) Returnable containers sold empty. To qualify for this exemption the returnable container must be resold with the purpose of refilling. The sale of returnable containers to the original or first user thereof is taxable.

(e) Definitions.

(1) Returnable containers. As used in this regulation [45 IAC 2.2], the term returnable container means containers customarily returned by the buyer of the contents for reuse as containers.

(2) Nonreturnable containers. As used in this regulation [45 IAC 2.2], the term "nonreturnable containers" means all containers which are not returnable containers.

The above statute exempts non-returnable packaging, for example the stretch wrap Taxpayer uses. However because at this point the stretch wrapping equipment is no longer directly being used in the direct production process, the equipment itself is not exempt.

FINDING

Taxpayer's protest of the assessment of use tax on its use of de-palletizing equipment is denied (see subsection A).

Taxpayer's protest of the assessment of use tax on its use of a box turner conveyor and palletizer is sustained (see subsection B).

Taxpayer's protest of the assessment of use tax on its use of a stretch wrapper is denied (see subsection C).

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